

BEFORE THE  
POSTAL REGULATORY COMMISSION  
WASHINGTON, DC 20268-0001

DISCOVER NSA

Docket No. MC2011-19

DISCOVER NSA

Docket No. R2011-3

**RESPONSE OF THE UNITED STATES POSTAL SERVICE TO  
PUBLIC REPRESENTATIVE'S AND VALPAK'S COMMENTS**

(APRIL 11, 2013)

On March 15, 2011, the Postal Regulatory Commission (Commission) found that the Discover Financial Services (DFS) Negotiated Service Agreement 1 (NSA) complied with 39 U.S.C. 3622 and 3642, as well as 39 CFR 3010 and 3020, et seq. and added it to the market dominant list.<sup>1</sup> On March 8, 2013, the Postal Service filed an Amendment to the DFS NSA with the Commission.<sup>2</sup> The Amendment seeks to neutralize the revenue adjustment threshold in Year 3 of the agreement against penalizing DFS for shifting a small portion (<1%) of its First-Class Mail to Priority Mail, a product that yields more revenue and contribution for the Postal Service than First-Class Mail. The NSA revenue adjustment threshold forces DFS to compensate the Postal Service for decreasing its First-Class Mail volume by requiring DFS to mail more Standard Mail. The proposed Amendment is intended to treat this Priority Mail as if it were

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<sup>1</sup> Docket Nos. R2011-3/MC2011-19, Order No. 694, Order Adding Discover Financial Services 1 Negotiated Service Agreement to the Market Dominant Product List, March 15, 2011.

<sup>2</sup> Docket Nos. R2011-3/MC2011-19, Letter from Brandy A. Osimokun, Attorney, United States Postal Service to Shoshana M. Grove, Secretary, Postal Regulatory Commission, Re: Docket No[s]. R2011-3/MC2011-19, March 8, 2013.

First-Class Mail only for purpose of determining whether it is necessary to trigger the revenue adjustment threshold; the Priority Mail volume would not be subject to a rebate under the DFS NSA.

In Order No. 1676, the Commission scheduled the deadline for comments for March 27, 2013, but extended that deadline to April 2, 2013 in Order No. 1684 to afford interested persons an opportunity to consider the Postal Service's responses to Chairman's Information Request Nos. 3 and 4. DFS, Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (Valpak), and the Public Representative (PR) filed comments.<sup>3</sup> DFS' comments explain its rationale for shifting some of its First-Class Mail to Priority Mail and provide more details about the Amendment and its effect on the original DFS NSA. Valpak and the PR request that the Commission, not only reject the proposed Amendment, but terminate the original DFS NSA for failing to comply with the requirements of 39 U.S.C. § 3622(c)(10)(A) and proposing an illegal tying of a market-dominant and competitive NSA. The PR also suggests that the Postal Service's response in the data collection report, justifying its approach over the Commission methodology, is insufficient.

Historically, the Commission has provided the Postal Service with considerable latitude to formulate its response to the characteristics of a particular proposal when providing a financial analysis, because it understands that the Postal Service is in a good position to know generally what information is

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<sup>3</sup> Docket Nos. R2011-3/MC2011-19, Comments of Discover Financial Services (DFS Comments), March 26, 2013; Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Comments on Contract Amendment To Discover Financial Services Negotiated Service Agreement, April 2, 2013 (Valpak Comments); and Public Representative's Comments (PR Comments), April 4, 2013.

relevant, and must be submitted, and what is not relevant and need not be submitted.<sup>4</sup> The Commission provided the Postal Service with this latitude when it initially approved the DFS NSA, and again when it analyzed the first data collection report in its Annual Compliance Determination (ACD). This docket was reopened for the sole purpose of evaluating whether the Amendment complies with 39 U.S.C. § 3622(c)(10)(A). The Postal Service submits that, procedurally, the attempts by the PR and Valpak to induce a subsequent review of the DFS NSA are inappropriate.<sup>5</sup>

The Postal Service's comments here will restate how the Amendment complies with 39 U.S.C. § 3622(c)(10)(A) and address the argument that tying market-dominant and competitive products in the manner proposed in the amendment would invalidate the existing NSA.

#### **I. The DFS NSA Amendment Complies with 39 U.S.C. § 3622(c)(10)(A).**

The DFS NSA must either (i) enhance the Postal Service's operations or (ii) improve the net financial position of the Postal Service.<sup>6</sup> The Postal Service does not believe that the proposed Amendment changes the conclusion that this agreement satisfies 39 U.S.C. § 3622(c)(10). Valpak suggests that the Commission should take a two prong approach to its review: (1) view the

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<sup>4</sup> Docket No. RM2003-5, Order No. 1391, Order Establishing Rules Applicable To Requests For Baseline and Functionally Equivalent Negotiated Service Agreements, February 11, 2004 at 31-32.

<sup>5</sup> In the ACD2012, the Commission found that the Year 1 results of the DFS NSA are inconsistent with section 3622(c)(10). It recommended that the Postal Service reevaluate the benefits and costs of continuing the DFS NSA if the Postal Service is not realizing a net benefit due to the agreement or the insights gained by its implementation at the end of Year 2.

<sup>6</sup> See 39 U.S.C. § 3622(c)(10)(A).

Amendment in the context of the performance of the DFS NSA to date,<sup>7</sup> and (2) analyze the net financial effect of year 2 of the DFS NSA to determine whether the DFS NSA, including the Amendment, should be permitted to proceed.<sup>8</sup> Treating a trivial amount of Priority Mail that DFS shifts out of First-Class Mail as though it were First-Class Mail does not change the financial analysis the Postal Service originally submitted when the DFS NSA was approved.

The volume shifting to Priority Mail was already included in the Postal Service's volume and revenue trends and expectations for current and future economic conditions affecting DFS' First-Class Mail. Crediting DFS' First-Class volume for this higher contribution product does not change the value of the agreement. Rather, it prevents DFS from being penalized for using a product that, in the long run, provides more revenue and contribution to the net finances of the Postal Service generally, in the context of a provision intended to penalize DFS for using products that provide less revenue and contribution to the net finances of the Postal Service.

Further, in Order No. 694, the Commission's approval of the DFS NSA was not predicated primarily on it improving the net financial position of the Postal Service, but, rather, on permitting the Postal Service to enhance its knowledge of potential tools to slow the overall declining trend for First-Class Mail volume.<sup>9</sup> The Amendment will not significantly impact the Commission's

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<sup>7</sup> Valpak Comments at 2.

<sup>8</sup> Valpak Comments at 3.

<sup>9</sup> Order No. 694 at 15.

original conclusion in this regard, and it should not be viewed any differently.

The Postal Service's second data collection report will address the insights that it has gained from implementation of the DFS NSA and Amendment, if approved.

The PR observes that shifted Priority Mail will increase the likelihood that DFS will meet the revenue threshold, which will cause the Postal Service to pay rebates to DFS for volume growth unrelated to those rebates and reduce DFS's net contribution to the Postal Service.<sup>10</sup> In this regard, the PR admits that the additional cost to DFS of upgrading a small amount of volume to Priority Mail is so high, and the benefit to DFS's position in the NSA so meager, that it would be irrational for DFS to base its decision to use Priority Mail on the benefit that it would gain as a party to an amended NSA.<sup>11</sup> This conclusion, however, does not undermine the purpose of the NSA, which is to induce the retention of DFS First-Class mail volume or, alternately, to compensate the Postal Service for the loss of DFS First-Class contribution by increasing DFS Standard Mail contribution.

While this negligible amount of Priority Mail could increase the likelihood that DFS will meet the revenue threshold, the Postal Service will only be paying rebates on DFS' actual First-Class and Standard Mail volume, so the rebates paid out will be related to DFS' actual volume growth in only those particular classes of mail. The contribution that the Postal Service will receive generally will also increase due to the higher revenue and contribution resulting from DFS mailing some of its credit card kits using Priority Mail, versus First-Class Mail.

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<sup>10</sup> PR Comments at 4.

<sup>11</sup> PR Comments at 5.

Moreover, the Postal Service accepts that the business decision by DFS to use Priority Mail for new credit card fulfillment is based on an assessment of the overall business value to DFS. Priority Mail offers improved transit time, consumer impact, improved image, and greater acceptance rates. All these components add to the overall effect of the decision. The enhanced likelihood that a consumer receiving a Priority Mail piece will open the new card package immediately, and begin usage, has value for DFS. Accordingly, the behavior affected by the Amendment offers potential benefits to both DFS and the Postal Service. DFS will experience some marketing benefit, and the Postal Service will be informed in its effort to test innovative ways to counteract the effects of declining First-Class Mail. Increased contribution for the Postal Service from the Priority Mail would be an added, but ancillary benefit, which has nothing to do with the NSA.

The PR contends that “rebates cannot reasonably be expected to drive volumes where the categories of mail purchased have small price elasticities, the rebates are a small percentage of the total price, and, to qualify for them, a bulk mailer must adjust its entire purchase of a mail category, in order to qualify for those rebates.”<sup>12</sup> The PR also claims that, when small marginal discounts are applied to large volumes, very high elasticities are required to incentivize enough volume for net contribution to be positive.<sup>13</sup> Consequently, the PR recommends that the Commission should condition its approval of the Amendment on a good

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<sup>12</sup> PR Comments at 9.

<sup>13</sup> PR Comments at 9-10.

faith attempt by the Postal Service to answer the extent to which the own-price elasticities that the Postal Service implicitly assumes for Discover differ from the relevant market averages.<sup>14</sup>

As the Postal Service discussed in the initial review of the DFS NSA, applying system-wide elasticities to estimate the behavior of any particular mailer is challenging, where the change in behavior of the mailer that the NSA seeks to influence is the result of a complex interplay of factors.<sup>15</sup> Different factors have more relative importance to different customers. Each customer makes decisions based on its evaluation of its particular circumstances. As a consequence, trying to evaluate each customer using identical models can produce misleading results.<sup>16</sup> In this regard, the logic supporting the Postal Service's approach is completely compatible with the policy embodied in 39 U.S.C. § 3622(c)(10), which favors specialized classifications with particular mailers.

The DFS NSA is the Postal Service's first of two domestic NSAs negotiated since the enactment of the PAEA. As the Postal Service gains experience with these agreements, learns more about customer reactions, and, as it accumulates more data against which it can evaluate theories, models, and estimation techniques, it should be better equipped to provide the Commission with a superior methodology. Incidentally, the Postal Service notes that, in evaluating the DFS NSA, the Commission recognized that, while a quantitative

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<sup>14</sup> PR Comments at 14.

<sup>15</sup> Docket Nos. R2011-3/MC2011-19, Response of the United States Postal Service to Comments of the Public Representative, February 11, 2011 at 4.

<sup>16</sup> *Id.*

model for measuring estimated volumes absent the agreement would be valuable, non-problematic data are not always available.<sup>17</sup> The Commission affirmed that, in connection with the collection of data, any insight that the Postal Service would gain to enhance its knowledge of potential tools to slow the overall declining trend for First-Class Mail volume, or compensate for the loss of contribution, would make the Postal Service better off in the long run as a result of this agreement.<sup>18</sup>

## **II. This Market-Dominant NSA Will Not Impact the Market for Competitive Products.**

The Amendment will not impact the market for competitive products. Section 3642 requires the Postal Service to categorize each of its products as either market-dominant or competitive.<sup>19</sup> Such categorization of products is required because it governs the regulations and procedures the Postal Service must follow, and the standards applicable, when introducing, modifying or removing a product. These categories also create a framework for the Commission in its regulation of the Postal Service's products.

Valpak and the PR claim that the Amendment transforms the agreement into a hybrid market-dominant and competitive NSA, which “breaches” the wall “that prevents the Postal Service from using its market power over market dominant products as leverage to gain an advantage in competitive markets.”<sup>20</sup>

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<sup>17</sup> Order No. 694 at 15.

<sup>18</sup> Id. at 15-16.

<sup>19</sup> See 39 U.S.C. § 3642

<sup>20</sup> Valpak Comments at 4 and PR Comments at 12.



They erroneously allege that the Amendment uses one set of rebates to simultaneously incentivize the purchase by DFS of market dominant (Presort First-Class) and competitive services (Priority Mail), and that this is a misuse of monopoly power in the PAEA.<sup>21</sup>

Valpak's and the PR's arguments are overstated, and present issues that need not be decided in this docket. The Amendment modifies a market-dominant NSA, and treats an inconsequential amount of Priority Mail as though it were First-Class Mail for a narrow purpose. The Postal Service never requested that the Amendment transform the NSA into a product with a "dual listing." The Postal Service also never requested that the NSA be treated any differently from any other market-dominant product, in terms of the requirements it must meet under the PAEA.

It might be argued that an NSA could be anticompetitive, if eligibility for a discount on the market dominant side were predicated on sending competitive volumes. This would create a situation where a mailer would have an incentive to use Postal Service competitive products more than it would otherwise in order to gain access to the market dominant discount. The PR argues that, if the volumes of Priority Mail involved in the amended NSA constituted a significant share of the competitive market, it could potentially create an illegal tying under Section One of the Sherman Act and violate section 3622(c)(10)(B).<sup>22</sup> However, this is not the case here.

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<sup>21</sup> Valpak Comments at 5 and PR Comments at 12.

<sup>22</sup> PR Comments at 12.

The Priority Mail rates and service at issue here are not changed by the DFS NSA or the Amendment. The Amendment does not materially affect competition, and the Commission would in no way create a wide-ranging precedent by approving it. The Postal Service also is not conditioning access to the rebate on DFS sending Priority Mail, but is simply treating a piece of Priority Mail, as if it were First-Class Mail, for the purpose of determining whether it is necessary to adjust the revenue threshold. In this regard, the PR states that DFS' decision to use Priority Mail is independent of the terms of the DFS NSA and the Amendment, and these agreements have no influence over DFS' decision to mail.<sup>23</sup> The PR's allegations of competitive effects rely on a presumed connection between market-dominant rebates and DFS' decision to employ competitive product volume. As explained previously, this is not the case. DFS is making independent business decisions not incentivized by the Amendment.

### **III. The Postal Service Followed Proper Procedures.**

The suggestion by Valpak that the Postal Service has not followed proper procedures is without merit.<sup>24</sup> Valpak acknowledges that the Commission's Rules do not explicitly address Amendments to NSAs.<sup>25</sup> The Postal Service generally signs agreements prior to seeking review from the Commission. It also includes a provision in the agreement that conditions implementation of the

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<sup>23</sup> PR Comments at 8-10.

<sup>24</sup> Valpak Comments at 5-7.

<sup>25</sup> Valpak Comments at 6-7.

agreement on the Governors' and Commission's approvals. The Amendment is no different. It did not nullify the original DFS NSA, but merely added a sentence to an existing section. While the Commission does not require the NSA to be signed, it does not forbid it. It only requires that the Postal Service attach a copy of the agreement, which it did.

The Postal Service did seek the approval of the Governors. The Postal Service also filed a letter, including the amendment, with the Commission. In this regard, there is no required procedure to notify the Commission of an amendment to a market-dominant NSA. It was never the intention of either of the NSA parties to usurp the Commission's authority to review the merits of the Amendment.

#### **IV. Conclusion**

The Postal Service believes that this Amendment meets the statutory requirements for NSAs under the PAEA and Commission rules. As such, the Postal Service respectfully requests, that the Commission agree that the Amendment may be implemented.

Respectfully submitted,

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